Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Oropeza | Analyst: Jeff Garnier | Bill Number: AB 263

Related Bills: See Prior Analysis | Telephone: 845-5322 | Amended Date: June 16, 2004

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Dividends Received Deduction/Ceridian Issue/FTB Report to Legislature Regarding Tax Collected Pursuant to Dividend-Received Deduction

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

____ FURTHER AMENDMENTS NECESSARY.

__X__ DEPARTMENT POSITION CHANGED TO Support.

__X__ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED June 2, 2003, STILL APPLIES.

____ OTHER - See comments below.

SUMMARY

This bill would amend the tax statute that allows a deduction for dividends received by a parent corporation from an insurance company subsidiary because the statute was previously found to be unconstitutional. The bill would also provide disincentives for corporations subject to tax under the Corporation Tax Law (CTL) to overcapitalize insurance subsidiaries that are subject to the insurance gross premiums tax instead of the corporate income tax.

SUMMARY OF AMENDMENTS

The June 16, 2004, amendments made the following changes:

- Increased the dividends received deduction (DRD) percentage starting in taxable years beginning on or after January 1, 2008, from 80% to 85%.
- Reduced the DRD percentage for prior or open years from 90% to 80%, modified the election provision, and deleted the provision to repeal the deduction for prospective years if less than $15 million is collected for the prior or open years. It also removed the provision making all dividends received during the election period business income.
- Added a provision that would phase out the DRD if an insurance subsidiary is overcapitalized or self-insures the parent.
- Added several provisions that would discourage corporations subject to tax under the CTL from transferring unrealized income or gains to an insurance subsidiary or deciding to keep earnings and profits in an insurance subsidiary.

Board Position:			Department Director	Date
__X__ S	_____ NA	_____ NP		
_____ SA	_____ O	_____ NAR	Brian Putler	7/13/04
_____ N	_____ OUA	_____ PENDING		

LSB TEMPLATE (rev. 5-03)

- Deleted the requirement that the Franchise Tax Board (FTB) report to the Legislature regarding the amount collected for open years, but added a requirement that the Legislative Analyst conduct a study and submit a report to the Legislature.

Except for the above items, the remainder of the department's analysis of the bill as amended June 2, 2003, still applies. For background information on the *Ceridian* decision (*Ceridian Corp. v. Franchise Tax Board* (2000) 85 Cal.App. 4th 875 (modified 86 Cal.App. 4th 483)) and current law, see the department's analysis for the bill as introduced on February 4, 2003. For convenience, the THIS BILL section included in this analysis supersedes all previous analyses.

POSITION

Support.

On June 10, 2004, the Franchise Tax Board voted to support this bill.

ANALYSIS

OVERCAPITALIZATION AND SHELTERING OF INCOME

Generally, an insurance company is taxed differently than a general corporation by the federal government, the State of California, and many other states. The federal government does not tax an insurance company that earns premiums less than $300,000. Moreover, an insurance company that earns premiums between $300,000 and $1,000,000 is taxed at a reduced rate.

Under California law, an insurance company is not subject to franchise or income tax under the CTL within the Revenue and Taxation Code (RTC). Instead, an insurance company pays a 2.3% gross premiums tax on the premiums it receives. Consequently, an insurance company does not directly pay tax on interest, dividends, rents, royalties, or any other investment income. The inherent difference between the tax base of the franchise or income tax and the gross premiums tax arguably creates an unintended "tax loophole." Examples of the unintended results that can occur as a result of the interaction between the two separate tax bases are:

- A general corporation, subject to tax under the CTL, transfers a low basis, high value asset to an insurance company subsidiary in a transaction that otherwise qualifies as a tax-deferred transaction under the CTL. The insurance company then sells the asset and recognizes a large gain. The gain is not taxed under the CTL, nor is the gain taxed by the gross premiums tax. The insurance company then dividends the profits on the sale to the parent corporation, where if applicable a DRD will be taken, thereby effectively sheltering most of the otherwise taxable gain from the combined tax bases (CTL and gross premiums). This example is referred to as "round-tripping."

- A Wall Street Journal article (D. Johnston, *Insurance Loophole Helps Rich* (April 1, 2003)), describes two actual situations that serve as good examples of where an insurance company received minimal premiums compared to the income it realized from assets it owned (where the income from assets owned was sheltered from taxation). One insurance company received only $3,300 in premiums but held assets of $330 million, the other received only $300,000 in premiums while earning $45 million in tax-free profits on assets of $530 million. The profits earned by the two insurance companies are eventually paid back to the parent corporation as a dividend where the DRD could apply to exempt most of the dividend from the general tax base.

- The sheltering of income from the CTL can also be done without a DRD. Assume a general parent transfers a valuable trademark to its insurance company subsidiary. The general parent pays royalties to the insurance company for use of the trademark. The royalties are deductible to the general parent and not subject to the gross premiums tax for the insurance company. Since the parent owns the insurance company, the parent essentially deducts royalties paid to itself. This example provides tax savings without a DRD. If the insurance company profits (from royalties received on the trademark) are then paid back to the parent corporation as a dividend and a DRD applies, additional tax saving incentives are provided by the law.

The above examples apply to a mainstream insurance company as well as a large conglomerate general corporation that forms a "captive insurance company." A captive insurance company is an insurance company formed to insure the owner of the insurance company. A captive insurance company is formed, as opposed to merely setting up a loss reserve, to take advantage of tax benefits under federal and state law. Generally, all or most of the "captive" insurance is sold to the parent. A captive insurance company is not an insurance company in the normal sense of the term because the risk associated with the insurance is not transferred outside of the parent corporation's affiliated group. Because the risk of loss remains with the parent and its affiliates, the primary purpose of self-insuring is the designed tax benefits. This form of self-insurance, due to the non-arms-length relationship, has been identified as a potential area of abuse that far exceeds the designed tax benefits of forming a captive insurance company.

Another Wall Street Journal article (J. McKinnon, *Vermont Captives* (January 12, 2004)) discusses how some states, such as Vermont, have very liberal insurance regulations for captives. This permits a general corporation to "park" income producing assets "far in excess of what is needed" to pay potential claims to exploit unintended loopholes between the franchise tax and the gross premiums tax. The article cites two states, Illinois and New Mexico that are actively pursuing the overcapitalization of captive insurance companies.

Overcapitalization is difficult to identify. Non-captive insurance companies in this country are highly regulated by the states. One of the main goals of a state insurance commissioner is to assure that the insurance company has adequate reserves or assets to cover all claims submitted by policyholders. Therefore, an insurance commissioner is concerned about undercapitalization rather than overcapitalization. The National Association of [state] Insurance Commissioners (NAIC) has adopted uniform rules on capitalization requirements; however, non-domestic insurance companies and captives are not subject to these rules.

THIS BILL

1. This bill would repeal and re-enact Section 24410 to allow a taxpayer that owns 80% or more of a subsidiary engaged in an insurance business to an 80% DRD for qualified dividends received from that subsidiary. The deduction would be allowed regardless of whether the insurance company is engaged in business in California. The 80% deduction would apply to taxable years beginning on or after January 1, 2004, and would increase to 85% for taxable years beginning on or after January 1, 2008.

2. This bill would require the dividends received that qualify for the DRD to be phased-out if the insurance company paying the dividend is overcapitalized. A phase-out ratio utilizing premiums and investment income is used to calculate the amount of overcapitalization. The overcapitalization ratio or percentage is calculated by dividing the five-year average of premiums earned by the five-year average of total income earned. The lower the percentage, meaning the greater investment or non-taxable income in relationship to premiums, the more the insurance company is overcapitalized. Total income is equal to premiums earned plus investment income. Premiums earned by a life insurance or financial guaranty insurance company are weighted at a higher amount The overcapitalization percentage reduces dividends received that qualify for the DRD by the general parent corporation as follows:

    - If the overcapitalization percentage is equal to or greater than 60% (70% beginning in 2008), the dividends qualifying for the DRD are not reduced.

    - If the overcapitalization percentage is less than 60% (70% beginning in 2008) and greater than 10%, then the dividends qualifying for the DRD is ratably reduced for each percentage point by which the overcapitalization percent falls below 60% (70% beginning in 2008). For example, if the overcapitalization percentage is 30%, the dividends qualifying for the DRD is reduced by 50%. The 30% is one half of the amount necessary (60%) not to be overcapitalized, therefore, one half of the dividends qualifying for the DRD is phased-out.

    - If the overcapitalization percentage is equal to or less than 10%, the dividends qualifying for the DRD are reduced to zero.

    Premiums received from the insurance company's affiliates and the investment income earned on those premiums are not included in the overcapitalization ratio computation.. Additionally, the bill would provide that dividends received from an insurance company that is derived from profits on premiums received by the insurance company from related affiliates do not qualify for the DRD.

    The bill would provide instructions and definitions needed to compute the overcapitalization ratio and would delegate to the Franchise Tax Board the authority to write regulations in narrowly identified situations.

3. For taxable years ending on or after December 1, 1997, and beginning before January 1, 2003, a taxpayer could elect to deduct 80% of dividends received from an insurance company subsidiary. The taxpayer must make the election on at least one return for the election period (1997 to 2002). The election must be made within 180 days of the effective date of the bill. By making the election, the taxpayer would agree to all of the following:

    - To be subject to the DRD percentage and the phase–out of the qualified dividends received discussed in Item 2 above for all taxable years in the election period.

    - To report and remit any amounts due pursuant to the election for all open taxable years in the election period. This remittance must occur within 180 days of the effective date of the bill or by the due date of the return for taxable years where the return is due more than 180 days after the effective date of the bill.

    - No refund, credit, or offset may be allowed for a DRD in excess of the amounts allowed under the provision for the election period.

The election would be irrevocable once made and would apply only to taxable years during the election period for which the statute of limitations is open. Where the statute of limitations has closed for any particular year during that period, the election would apply if the final determination of tax has not been made for the taxable year because of a dispute related to the dividends received deduction or Section 24425 (expenses incurred in connection with income not included in the tax base under the CTL, as it relates to the DRD under Section 24410).

For purposes of determining taxable income for the taxable years during the election period only, RTC Section 24425 would not apply to any expense related to Section 24410 dividends. Thus, taxpayers would not be required to reduce any expenses related to the Section 24410 dividends.

4. For taxable years beginning on or after January 1, 2004, this bill would modify Section 24425, which relates to expenses incurred in connection with income not included in the tax base under the CTL. The following interest or other expense paid to an affiliated insurance company would be disallowed as follows:

   - Interest paid on indebtedness (except specified marketable debt instruments) the principal of which is attributable to a contribution of capital from a noninsurer member of the group.
   - Interest paid within the last five years in connection with the acquisition of the insurance company.
   - Interest paid multiplied by the disqualifying percentage, which is determined by subtracting the percentage of dividends that would have been qualified for the DRD under Item 2 above from 100%, whether or not a dividend is paid. In the example given above, the overcapitalization percentage was 30% and the dividends qualifying for the DRD is reduced by 50%. Therefore, 50% of all interest paid to an affiliated insurance company would be disallowed regardless of whether the insurance company paid a dividend in the year the expense was incurred.
   - Interest paid multiplied by the greater of the ratio of: --
     - Premiums received from affiliates divided by total premiums received.
     - Associated risk with insurance polices sold to affiliates divided by the associated risk with all insurance polices.
   - Expenses attributable to property acquired by an insurance company from a non-insurance company affiliate where no gain was required to be recognized by the non-insurance company affiliate.
   - Expenses attributable to property acquired by an insurance company with proceeds from a contribution of capital from a non-insurance company affiliate.

   The bill provides that any interest or other expense described in one or more of the bullets above shall only be included once, and shall be included in that bucket that results in the highest disallowance amount.

5. Except as specified, the bill would provide that if a taxpayer transfers appreciated property to an insurance company in an exchange described in specified provisions of the Internal Revenue Code, the insurance company shall not be treated as a corporation for purposes of determining whether gain from that transfer or exchange will be recognized. The effect of that rule would disable the effects of nonrecognition provisions dealing with various transactions involving corporations and their instruments, thus making the exchanges a taxable event. The specified provisions of the Internal Revenue Code are:

Section 332 – Complete Liquidations of Subsidiaries,
Section 351 – Transfer to Corporation Controlled by Transferor,
Section 354 – Exchanges of Stock and Securities in Certain Reorganizations,
Section 356 – Receipt of Additional Consideration, or
Section 361 – Nonrecognition of Gain or Loss to Corporations; Treatment of Distributions.

The bill provides exceptions to the above general rule, unless the transfer or exchange has the effect of removing the property from the CTL tax base. This effectively prevents low tax basis, high fair market value assets (appreciated property) of the non-insurance company affiliate from being transferred out of the CTL tax base to the gross premiums tax base where the gain on the property, if disposed of by an insurer, would not be subject to any tax. The exceptions provided are:

- Transfers due to certain statutory mergers using voting stock of the parent corporation.
- Transfers of stock for the purpose of filing a federal consolidated tax return, financial statements, or regulatory reporting.
- Transfers of stock for publicly owned stock of the general parent corporation.

An exception to the immediate recognition of gain rule by the non-insurance company affiliate would allow deferral if the insurance company uses the property in the active conduct of its trade or business. The gain will be deferred until property is no longer used in the insurance company's or a combined reporting affiliate's trade or business or the property is no longer owned by the insurance company or a combined reporting affiliate in the group. If the deferred gain was business income to the original transferor, then when restored, the business income is apportioned using the transferor's current year's apportionment percentage. The gain on certain types of property, including inventory, copyrights and intangibles, would not be permitted to be deferred under these rules. Under regulations, the Franchise Tax Board may prescribe reporting requirements for the deferral of gains under this provision on property transferred to an insurance company to ensure that gain is recognized when the appreciated asset leaves the trade or business of the specified members of the commonly-controlled group under the circumstances specified in the bill. The bill also provides that if these reporting requirements are not met, then the Franchise Tax Board may require the gain deferred to be included in the income of the taxpayer in the year the reporting requirement was not met. The Franchise Tax Board may propose an assessment resulting from not meeting these reporting requirements for up to four years after the taxpayer again meets the reporting requirements (and discloses that the asset has left the group, or is no longer a part of the trade or business of the specified members of the group). In other words, if the taxpayer does not meet the reporting requirements, the Franchise Tax Board may issue an assessment at any time.

The bill provides for additional narrower exceptions to the above and also narrowly expands the recognition of gains to which this provision applies. Numerous rules and definitions are also provided. The Franchise Tax Board may prescribe regulations appropriate to carry out the purpose of this provision, which is to prevent the removal of gain from the CTL tax base. Additionally, if the taxpayer demonstrates that a transfer of property does not violate the purposes of this provision, which is to prevent the removal of gain from the CTL tax base, the Franchise Tax Board may grant relief. The State Board of Equalization or a court may also grant relief from this provision if the State Board of Equalization or court makes a specific finding that the transfer did not remove gain inherent in property from the CTL tax base.

6. The bill would provide that under certain conditions the Franchise Tax Board may include in the general parent corporation's gross income a deemed dividend (qualifying for the DRD under Item 1 above) from the parent's insurance companies. This applies if all insurance companies in an affiliated group have an overcapitalization percentage (discussed in Item 2 above) that is equal to or less than 10% (15% beginning in 2008) and a substantial purpose of the accumulation of earnings and profits of the insurance company was to avoid income tax of this or any other state. The deemed dividend amount would be equal to the pro rata share of all of the affiliated insurance companies' earnings and profits for the taxable year. The amount of the deemed dividend drawn from an insurer cannot exceed that specific insurance company's net income attributable to investment income (as defined) less the insurance company 's premiums. Any amount included in the income of the general corporation in one year cannot again be considered in a following year.

   If all insurance companies in an affiliated group constitute a "predominantly captive insurance group," this provision applies if the overcapitalization percentage (discussed in Item 2 above) is equal to or less than 40%. A "predominantly captive insurance group" means an affiliated group of insurance companies if either of the following ratios exceeds 50%:

   - Unweighted premiums received from affiliates divided by total unweighted premiums received.
   - Associated risk with insurance polices sold to affiliates divided by the associated risk with all insurance polices.

   The bill provides that the Franchise Tax Board may prescribe regulations relating to an affiliated group of insurance companies to describe conditions where accumulation of earnings and profits do not have the substantial purpose to avoid taxes on or measured by income.

   The bill also provides that if any part of this deemed dividend provision is found invalid, the invalidity shall not apply to any other provision in the bill or any severable portion of the provision.

7. The Legislative Analyst, in consultation with the Department of Finance, Department of Insurance, and the Franchise Tax Board, must report to the Legislature by January 1, 2008, the following:

   - State the impact of the deemed dividend provision (Item 6) on the ability of taxpayers to use insurance companies to avoid state taxes. The report shall address whether the 15% overcapitalization percentage used beginning in 2008 should be decreased to 10%.
   - Compare the gross premiums taxes paid and the method of collection of the tax by insurance companies to taxes paid and collected under the CTL.

8. The bill also would make the following legislative declarations:

   - The amendments to Section 24410 serve a public purpose and are necessary to provide for the equitable tax treatment of insurance company dividends in light of: (1) the *Ceridian* decision holding that Section 24410 violates the Commerce Clause of the United States Constitution, (2) that insurance company dividends do not qualify for a deduction under Section 24402 and are not eligible for elimination from income as provided for in Section 25106, and (3) that a number of corporations filed returns claiming deductions for all or part of the dividends they received from insurance subsidiaries because of uncertainty following the *Ceridian* decision.

- The amendments to Section 24410 serve a public purpose and are in furtherance of the public interest in avoiding the denial of a deduction for insurance company dividends. Denial of this deduction would have a detrimental effect upon the economy of California.

- The retroactive application of the amendments to Section 24410 serve a public purpose and promote sound tax policy by affording equitable tax relief to taxpayers that relied upon Section 24410 in expectation that they would be entitled to a deduction with respect to a portion of the dividends received from insurance companies.

- Section 24425 denies a deduction with respect to any amount otherwise allowable as a deduction that is allocable to a class of income that is not included in the measure of tax. The Franchise Tax Board contends and the State Board of Equalization has held that where a taxpayer claims a DRD for insurance company dividends, deductions for expenses associated with those dividends are disallowed under Section 24425. In contrast, the industry contends that Section 24425 does not apply under any circumstance.

- The amendment to Section 24410 that declares Section 24425 to be inapplicable to the dividends received deduction for tax years ending on or after December 1, 1997, and before January 1, 2004, represents an integral part of the legislative resolution of the uncertainty created by the *Ceridian* decision, and accordingly furthers the same valid public purposes identified above.

- No inferences should be made with respect to the application of Section 24425 to the deductions allocable to dividends received deduction for taxable years ending before December 1, 1997, or beginning on or after January 1, 2003.

- The tax treatment of insurance company dividends as provided by this bill is unrelated to and distinguishable from the tax treatment of the deduction of general corporate dividends under Section 24402 and the application of Section 24425 to deductions allocable to those dividends.

ECONOMIC IMPACT

Revenue Estimate

The revenue implications of this bill depend on whether current law is no deduction or a 100% deduction for dividends received from an insurance company subsidiary. The current departmental practice is to deny any insurance dividend deduction. Assuming that no deduction is allowed, based on data and assumptions discussed below, this bill would result in the following cash flow revenue effects.

Cash Flow Revenue Effects of AB 263
As Amended June 16, 2004, With Enactment Assumed After June 30
[$ In Millions]

	2004-05	2005-06	2006-07	2007-08	2008-09
Open Years: 1997-2003 80% DRD and S24425 not applicable	-$183	-$69	$0		
Ongoing Years: 2004 and later 80% to 85% DRD	-$32	-$36	-$29	-$29	-$30
Total	-$215	-$105	-$29	-$29	-$30

The amendments of June 16, 2004, contain provisions that prevent overcapitalizing insurance subsidiary corporations. Absent these provisions, this bill would result in additional revenue losses. The additional losses would exceed $500 million by 2008-09 and continue to grow rapidly each year thereafter.

Revenue Discussion

As previously amended on June 2, 2003, cash flow revenue effects of the bill were +$15 million, -$177 million, and -$96 million in 2003-04, 2004-05, and 2005-06. As indicated in the table above, estimates for the bill as amended June 16, 2004, are quite different. Factors that contribute to the changed estimates are the following: (1) one additional year (2003) is added to the open year period, (2) enactment of the bill is pushed out an additional year–assumed after June 30, 2004, and (3) the assumption that these cases would be successfully resolved before the BOE by the FTB by year-end 2004.

Assuming current law does not provide a dividend-received deduction, the revenue impact of the bill would be determined by the amount of deductions allowed under the bill that would be otherwise denied under current departmental practice and any related decrease in tax liabilities.

The following steps derived the cash flow estimates above:

1. Calculated the liability year revenue gains from denying any deductions of insurance company dividends (estimated at $210 million plus interest for open years (1997-2003), and $35 million for each ongoing year beginning with 2004.
2. Compared approximated cash flows of denying a deduction and the department succeeding before the BOE with that of this bill and its proposed DRDs and no expense limitation for open years.

The second table provides the liability year estimates (tax only) for each of the various components for years indicated.

Tax Only Revenue Effects of AB 263 as Amended 6/16/04
Operative 1/1/04, Enactment Assumed After 6/30/04
[$ In Millions]

Open Years	1997-2003(Cumulative)				
80% DRD	-$168				
S.24425 Not Applicable	-$39				
Total	-$207				
Ongoing Years:	2004	2005	2006	2007	2008
Staged DRD Percentage	80%	80%	80%	80%	85%
80% to 85% DRD	-$28	-$28	-$28	-$28	-$30

Liability year losses were derived as follows. Audit staff conducted a survey that identified cases with insurance DRD issues in the current audit inventory. Case-by-case, auditors calculated the tax implications for either denying the claimed deduction or allowing a 100% deduction. As the bill proposes a somewhat reduced deduction, tax amounts were adjusted to reflect proposed deductions of 80% for open years and 80% for ongoing years before 2008, and 85% for 2008 and later. Tax implications were summed for each taxable year included in the audit survey. If survey data were limited or missing for certain open years, results were extrapolated from known years.

The projected additional tax collected under the bill for open years was derived as follows. Auditors examined a sample of corporate taxpayers with assessments or potential assessments for one or more open years (1997-2003) for significant amounts of additional taxes due to denying a deduction for insurance dividends. For each return, an auditor calculated the estimated tax effects of allowing a deduction at the proposed 80% and without limiting expenses related to deductible insurance dividends. Estimated tax effects were compared with self-assessed payments made by these taxpayers for each open year. Results were expanded to be representative for the universe of taxpayers with insurance dividends. At an 80% DRD, it is assumed virtually all taxpayers would elect to amend their returns.

LEGAL IMPACT

Currently, industry and department staff disagree regarding the application of RTC Section 24425 to insurance company dividends. The department contends and the SBE has held that where a taxpayer claims a dividends-received deduction for insurance company dividends, expenses allocable to income not included in the measure of tax are disallowed under RTC Section 24425 (thereby preventing a double benefit). In contrast, the industry contends that application of RTC Section 24425 causes double taxation and does not apply.

This bill would specify that Section 24425 does not apply for taxable years ending on or after December 1, 1997, and beginning before January 1, 2004. Consequently, the bill would impact nine cases currently on appeal at the Board of Equalization.

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